No. 17354

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CENTURY INDEMNITY COMPANY, a corporation,

Appellant,

vs.

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

Appellee,

and

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

Appellant,

vs.

CENTURY INDEMNITY COMPANY, a corporation,

Appellee.

Reply Brief for Appellant and Cross-Appellee Century Indemnity Company.

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Statement.

Although Taxpayer has no inclination or desire to be picayunish about the statement of facts in this case, which are in general stipulated or otherwise quite clear, in the interests of the record it appears that several points in the statements of facts as set forth in the brief for the District Director deserve comment as follows:

1. On page 6, it is stated that:

"The only job being performed by White-Ahlgren was the subcontract with Marine and at no time did White-Ahlgren receive any funds from any other job, contract or subcontract. [R. 83-85.]"

This statement apparently was taken from paragraph X of the Findings of Fact. [R. 84.] However, as that finding states, this referred to the period commencing March 9, 1954, and ending with the completion of the subcontract on September 17, 1954. As set forth in paragraph III (A)(12) of the Pre-Trial Conference Order [R. 51] White-Ahlgren [then named Wright-Ahlgren Company, Inc., see following paragraph (13)] had a contract with Webb-Knapp Company which had been entered into prior to the date of the contract here in question and on which work was still in progress on December 2, 1953, the date the surety bond was executed and the bank trust account was opened. All of White-Ahlgren's rights to payments under this contract were assigned to Taxpayer as of May 28, 1954. [R. 282.]

2. On page 7, the last sentence in the first paragraph reads:

> "The checks were deposited in the White-Ahlgren general account and checks to the individual employees were drawn from this account. [R. 84, 314.]"

Presumably this was understood to cover the entire period between December 7, 1953, and March 8, 1954. However, there were in fact 148 checks dated between December 18, 1953, and January 12, 1954, in the total amount of $9,630.18, payable to individual employees of White-Ahlgren, which were drawn not on the general account but on the trust account, signed by both Mr. Ahlgren and Mr. White, and which were honored by the bank without the required countersignature of a representative of Taxpayer. [Pltf. Ex. 36, R. 114-115.] This amount, in short, was improperly diverted. The testimony of Mrs. Cole is not entirely clear because of a discrepancy in dates. However, it appears obvious, and

it is believed to be a fair and reasonable inference from her testimony, that upon the discovery of this situation the procedure for handling payrolls was changed. Whereas, one payroll check for the gross payroll had theretofore been drawn on the trust account and deposited in the White-Ahlgren general account, thereafter one check for the net payroll was drawn on the trust account and deposited in the general account until March 9, 1954. [R. 110-117.]

3. On page 15 of the Director's brief the statement is made in the second paragraph that the evidence of record establishes that Taxpayer required the trust account as a condition precedent to its issuance of the bond. Again on page 17 it is stated that this requirement of Taxpayer was consummated in the establishment of "White-Ahlgren Trust Account No. 1".

Counsel for Taxpayer still fail to grasp the legal significance in this case of the motivation for the establishment of the joint control account since one was in fact established. The legal consequences flow from the fact—what was done—and not from why it was done.

However, since counsel for the Director apparently has consistently deemed the motivation for the establishment of the joint control account to be one of the significant factors in this case, the position of the Taxpayer should be made clear.

The Court below refused to find as a fact that Taxpayer required the opening of the "White-Ahlgren Trust Account No. 1" as a condition precedent to its issuance of the surety bond. The refusal of the Court to so find is alleged by counsel for the Director to be erroneous and is one of the points relied upon in his cross-appeal. [R. 336-337.]

It is submitted that the refusal of the Court below to make this finding is amply sustained by the record. Admittedly D. J. Waite, on behalf of Taxpayer, wrote the letter to the prime contractor stating the conditions under which the surety bond would be issued. [Deft. Ex. A, Appendix B of Director's brief.] This included the phrase "* * * which specific sum of money is to be deposited in a special bank account of White-Ahlgren Company, Inc., of which we as surety will have joint control, * * *." A joint control account was, of course, established.

However, what Government counsel obviously is attempting to establish is that Taxpayer would not have written the bond, absent the joint control requirement. In Taxpayer's view the letter [Deft. Ex. A] must be read in context. Mrs. Cole testified that Taxpayer did not require the joint control account but that Hertha Clausen, who was putting up some of the money, did. On cross-examination Mrs. Cole emphatically reaffirmed her testimony. [R. 101-104, 124.] Mr. Waite testified to the same effect, and specifically stated that the joint control was not an additional requirement of the surety company. [R. 187.] He also testified, as stated by Government counsel in the Director's brief, that he did adopt the suggestion of a joint-control account. [R. 195.] In short, the letter, when read in conjunction with the testimony, simply means that when certain things were done the bond would be issued. This is considerably different, it is submitted, from the interpretation placed on the letter by government counsel, namely, that unless a joint control account was established the bond would not be issued.

The refusal of the Court below to find that taxpayer *required* a joint control account as a *condition precedent* to its issuance of the surety bond is amply supported by the evidence. Unless and until this Court finds that the Court below erred in this regard, it is the understanding of counsel for the Taxpayer that the record, as now before this Court, is that the establishment of a joint control account was not a condition precedent to the issuance of the bond.

In his brief on pages 20 and 21 the Director makes much too broad an inference from the statement of the Court that the implication of Mr. Van Tassel's previous statement that there was not sufficient money in the trustee account to pay payroll taxes on a return prepared by White-Ahlgren was that the only reason it was not paid was that there wasn't any money and that the account owed the money, and if Century Indemnity had control of the account it owed the money, "if that is what you mean to say". The reply of Mr. Van Tassel was: "That is what I mean to say, that there was insufficient money in that account with which to meet those payroll taxes at that time and I therefore declined to countersign a check," and that was the only reason the tax was not paid. It is very important, however, to observe that prior to the above question by the Court and the answer by Mr. Van Tassel, the latter had said "They [the taxes] might have been collected in part at least, I would guess, from other assets of White-Ahlgren. I hadn't any knowledge as to that at that time. My knowledge of the situation was restricted to what the trustee account itself revealed as to a checkbook or a bank balance."

ARGUMENT.

The Subcontractor, and Not Taxpayer, Had Control of the Payment of Wages and Was the "Employer" Within the Meaning of Section 1621(d) of the Internal Revenue Code of 1939 as Amended.

A. Preliminary.

The sole issue now remaining on this appeal and cross-appeal involves liability for federal income withholding taxes, delinquency penalty and interest, for the fourth quarter of 1953 and the first three quarters of 1954. Two periods of time are involved.

1. The period December 7, 1953, to March 8, 1954. The District Court held that during this period Taxpayer did not have "control of the payment of the wages" of the employees of the subcontractor within the meaning of Section 1621(d)(1) of the 1939 Internal Revenue Code.

Cross-appellant, the District Director, contends that this holding is erroneous.

2. The period March 8, 1954, to September 17, 1954. The District Court held that during this period Taxpayer did have "control of the payment of the wages" of the employees of the subcontractor within the meaning of Section 1621(d)(1) of the 1939 Internal Revenue Code.

Appellant, the Taxpayer, contends that this holding is erroneous.

Cross-appellant, the District Director, necessarily directs his argument to the entire period, first to show error in the District Court's holding in favor of Taxpayer for the first period, and second to show the cor-

rectness of the District Court's holding in favor of the District Director for the second period.

With respect to the first period, for which Taxpayer here urges that the holding of the Court below be affirmed, a brief statement should suffice.

The record is clear that subcontractor had a general commercial bank account with which Taxpayer had no connection. [Pltf. Ex. 5, R. 312-313.] Beginning with ths first payroll under the subcontract on December 7, 1953, and until January 11, 1954, a check in the gross amount of the weekly payroll on this subcontract was deposited in this account. For the period between January 12, 1954, and March 8, 1954, a check in the net amount of each payroll was deposited in this account. The money on deposit in this account was not under the control of Taxpayer in any shape, form or fashion. In addition, it is pointed out that subcontractor drew individual payroll checks on the trust account which were honored by the bank even though not properly countersigned. These checks covered the period from December 18, 1953, to January 12, 1954, and were in the total amount of $9,630.18. [Pltf. Ex. 36, R. 114-115.] They should have been drawn on subcontractor's regular commercial account. The net effect of this was that a check for the payroll was deposited in subcontractor's commercial account, and individual payroll checks for the same payroll were also drawn on the trust account and cashed. [R. 200-201.]

Two points appear clear. During this period there was no control in fact over the payment of the wages of subcontractor's employees. If there were *legal* control of such payments, as urged by the Director, it is difficult to see upon what theory it can be urged that

it was exercised to his detriment and so as to prevent the subcontractor from paying the taxes in question.

Taxpayer will now direct its attention to two points which are the heart of the Government's argument. These points are as follows:

1. Did Taxpayer alone have legal control of the funds to be used for the payment of the wages?

2. Are the cases cited by Taxpayer controlling in this case?

B. Taxpayer Alone Did Not Have Legal Control of the Funds to Be Used for the Payment of the Wages.

In the District Director's brief a considerable portion of the argument is directed to an analysis of the evidence to show that Taxpayer required the establishment of "White-Ahlgren Trust Account No. 1" as a condition precedent to the issuance of the bond. This argument has been commented upon above and no useful purpose would be served by repeating it again here. It is next asserted that the statutory language "control of the payment of the wages" means legal control of such payments as pointed out in the Treasury Regulations [Treasury Regulations 120 (1939 Code), Section 406.205(c)], and that "the purpose of the trust was to vest legal control of the funds earned under the subcontract in the Taxpayer and this is exactly what was done." (Deft. Br. p. 17.)

Finding No. VI of the District Court [R. 83] is quoted here for the convenience of the Court:

> "White-Ahlgren Company, Inc., opened a commercial checking account in the Security Trust and Savings Bank of San Diego, California, on December 2, 1953, which said account was known as

> 'White-Ahlgren Trust Account No. 1,' over which White-Ahlgren Company, Inc., and plaintiff, as surety, would have joint control. The resolutions and signature cards filed with the aforesaid bank required all checks drawn against said Trust Account No. 1 by an authorized signatory of White-Ahlgren Company, Inc., to be countersigned by any one of several designated representatives of plaintiff who was to sign as trustee."

This finding states that subcontractor and Taxpayer, as surety, would have joint control over this account and that all checks drawn required an authorized signatory of subcontractor and the countersignature of any one of several designated representatives of Taxpayer who was to sign as trustee. This finding is not alleged to be erroneous by the District Director.

Title to said account and any balance therein was stated to be vested in and held by Taxpayer [Deft. Ex. B.] But for what purpose? The document plainly states:

> "* * * as security to the Century Indemnity Company that all funds to the credit of said account at any time shall be used *solely* for the purpose of paying bills for labor and material and all obligations entering into a certain construction project with reference to the completion of which said The Century Indemnity Company has executed an Indemnity Bond." (Emphasis Supplied.)

The factual situation before this Court is this: A joint control account, which required checks to be signed by the subcontractor and countersigned by a representative of the Taxpayer was established. The purpose of this joint control account was to insure that moneys paid

subcontractor by the prime contractor and deposited in this account were used solely to meet obligations incurred in connection with this contract.

What were the legal consequences? Did this arrangement place Taxpayer in "control of the payment of the wages" in question within the meaning of § 1621(d)(1)? The answer is, No.

The District Director relies on *United States v. Fogarty,* 164 F. 2d 26 (C. A. 8th), *United States v. Curtis,* 198 F. 2d 268 (C. A. 6th), and *In re Daigle,* 111 Fed. Supp. 109 (S. D. Me.). These cases involved trustees in bankruptcy and, as stated in the District Director's brief (page 25), hold that the trustees succeeded to the legal custody and control of the funds of the bankrupt out of which payment for the wages in question were made. The trustee was thus in control of the payment of wages within the intent of Section 1621(d).

There are two fatal weaknesses in the position of the District Director and in his reliance on these cases.

First, on this record and the findings of the Court below, it simply cannot be said that Taxpayer succeeded to the legal custody and control of the funds in the joint control account in the sense of a trustee in bankruptcy. There is no such analogy. This remained a joint control account for the entire period here involved.

Second, this same argument was advanced by Government counsel in *Westover v. William Simpson Const. Co.,* 209 F. 2d 908 (9th Cir., 1954). On page 22 of Appellant's brief, which was filed with this Court, Government counsel stated:

> "So far as the applicability of Section 1621(d)(1) of the Code is concerned, this case does not

> differ materially from *United States. v. Fogarty,* 164 F. 2d 26 (C. A. 8th), and *United States v. Curtis,* 178 F. 2d 268 (C. A. 6th), certiorari denied, 339 U. S. 965. * * *"

This was also the argument of the Government in the District Court and on the appeal in *United States v. Swedlow Engineering Co.,* 100 Fed. Supp. 796 (S. D. Cal. 1951), reversed by this Court in a *per curiam* opinion, *sub. nom., Fireman's Fund Indemnity Co. v. United States,* 210 F. 2d 472 (9th Cir. 1954). The Court in the *Simpson* case, *supra,* did not even consider it necessary to discuss this contention in its opinion. It has been uniformly rejected.

If the rationale of the *Simpson* case applies here, it is evident that the portion of the judgment of the Court below adverse to Taxpayer should be reversed and the portion in favor of Taxpayer should be sustained. To render the exception to the definition of "employer" contained in § 1621(d)(1) applicable, two things must be shown: (1) that the subcontractor had no control over the payment of the wages and (2) that the Taxpayer had. Obviously this requirement was not met. Whatever measure of control Taxpayer had was *not exclusive* but was *shared* with the subcontractor. (See *Simpson, supra.)*

C. The Cases Cited by Taxpayer Are Controlling in This Case.

The Director, in his brief, states that the *Simpson, Fireman's Fund* and *Southern Warehouse* cases, cited by Taxpayer are not controlling here. Why? Because in those cases there was merely an advance or loan of funds for the purpose of meeting the "take home" pay of the contractor's employees. Here Taxpayer had

"control" of *all* the funds received under the subcontract and was not merely advancing sufficient funds to meet net payrolls. (Director's Br. pp. 24-25.)

Is this really a sound distinction, and if so, is it controlling? It is respectfully submitted that both these questions must be answered in the negative.

Certainly this is not the position taken by the Government in those cases or the legal proposition there urged.

In the *Simpson* case the prime contractor agreed to meet the labor and material claims of a subcontractor as they fell due but only to the extent of the net amount due the laborers and materialmen. This was done through an acceleration of progress payments under the contract.

The money had been earned and when thus advanced belonged to the subcontractor. However, it was deposited in the name of the subcontractor in a "payroll trust account" which required the signature of a representative of the subcontractor, or the signature of only the prime contractor's representative, acting for and at the request of the subcontractor. The purpose of this arrangement, of course, was to ensure that the money would be applied to meet net "takehome" pay of laborers and other lienable claims under the contract.

The purpose of the trust account in the case before this Court was solely to ensure that the money received under the contract would be applied in payment of the wages of laborers and of lienable claims connected with it. In *Simpson,* this Court said: "Indeed, it is doubtful whether Simpson-Kier had any control over the wage payments." (P. 911.) This is interpreted by Taxpayer to mean that all Simpson-Kier did, by au-

thorizing its representative to sign checks on the account, was to see that the money was expended for the designated purposes, and that Simpson-Kier had no control over determining who the employees were, whether they should be paid, or how much. This is equally true of Taxpayer in the case now before this Court. The employees were all hired by the subcontractor, the payroll was prepared by it, and all Taxpayer did was to verify that the payroll checks corresponded with the actual payroll sheets before countersigning the checks. Certainly it had no discretion in the matter.

Next the Director urges that the *Simpson* rule does not apply here because Taxpayer, the bonding company, did not "loan or advance" money to the subcontractor as in the *Fireman's Fund* and *Reliance Insurance Co.* cases. Taxpayer did pay lienable claims under the contract of some $119,000.00 [Pltf. Ex. 20] and effected recoveries of some $70,723.64 [R. 67], leaving a net payment by Taxpayer of over $48,000.00. On the Director's theory, as understood by Taxpayer, the *Simpson* case would control here had Taxpayer "advanced" money to the subcontractor for payroll purposes and subcontractor had expended the money in the trust account for payment of other lienable claims, to wit, materialmen. However, if the converse procedure were followed, that is the money in the trust account were used to pay wages and the bonding company advanced money to pay materialmen the legal effect is entirely different. Simply to state the proposition is to demonstrate its fallacy. In all these cases there is one simple fact. Whatever the reason there simply is not enough money to go around. Who, then, is liable for the federal income withholding taxes?

Under the statutory exception to the definition of the term "employer" contained in § 1621(d)(1), it is clear, as stated in the Conference Report, that "If the wages are paid by a person other than the person for whom the services are or were performed, the term 'employer' means the *person paying such wages.* * * *" [Conf. Rep. No. 510, 78th Congress, 1st Session, 1943 Cum. Bull. 1351, 1353.] (Emphasis supplied.) Were the wages here in question paid by a person other than the person for whom the services were performed? Did Taxpayer have the measure of control of the wage payments required of the statutory exception? It is respectfully submitted that the answer is clearly, No.

Conclusion.

On the appeal of the Taxpayer, Century Indemnity Company, it is again submitted that the District Court's decision was in error in holding that the Taxpayer was the "employer" of the employees of the subcontractor between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a) and 1623 of the Internal Revenue Code of 1939, as amended, and that the Taxpayer was entitled to take nothing with respect to Withholding taxes and interest paid by the Taxpayer to Defendant for this period. This portion of the decision should be reversed. The remainder of the decision should be affirmed. It will be noted that on page 3 of his brief the Director states the holding of the District Court that judgment for re-

fund to Taxpayer of the FICA and FUTA taxes which it had paid to the District Director is not contested on appeal, and that the Director's appeal with respect to the taxing of costs in the District Court is withdrawn.

Respectfully submitted,

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